What Do Families Really Get from the Tax Cut?

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EXECUTIVE SUMMARY

In the Economic Growth and Tax Relief Reconciliation Act of 2001, Congress modified the President's original tax plan to provide more tax relief for lower-income working families and add additional tax benefits for retirement saving and education, while still remaining within the $1.35 trillion, 11-year constraint set by the budget resolution.

A smaller reduction in the top tax rate paid for some of the extras, but most of the additional tax relief was squeezed into the budget through a series of maneuvers and gimmicks. These included stretching out the phase-in of the rate cuts, delaying implementation of some provisions until the second five years, "sunsetting" other provisions after the fifth year, and sunsetting the entire Act at the end of 2010.

In addition, although the Tax Act provides modest relief from the Alternative Minimum Tax (AMT) in 2001 through 2004, it relies on the AMT in the later years to pay for a significant part of the tax cut, by reducing or eliminating the tax cut for an increasing number of families.

These convoluted maneuvers not only have serious budgetary implications, but at a more practical level, they have made it more difficult for people to determine what they will receive from this tax cut. This paper illuminates some key features of the tax cut by calculating how they will affect different representative families over each of the next ten years.

While the Act initially directs more tax relief toward lower-income families, the relative benefits to the highest-income households will grow dramatically over the 2001-10 period, as the cuts in marginal tax rates for higher-income taxpayers and the repeal of the personal exemption and itemized deduction phase-outs take effect.

- From 2001 to 2010, the inflation-adjusted value of the tax cut to married couples with two children and $20,000 of gross income (in 2001 dollars) will double. But for high- income families with $500,000 or $1 million in income, the cut will increase more than six-fold and ten-fold, respectively. However, a family with $200,000 in income will actually lose its tax cut entirely because of the AMT.

  Most single, childless taxpayers will receive a very small tax cut, that will shrink over time.

- In 2001, the new 10 percent bracket results in a tax cut of $300 for singles with at least $6,000 of taxable income. But singles with less income will receive a smaller tax cut. Moreover, by the time this bracket is indexed for inflation, the real value of the tax cut is less than $300. Only about one-fourth of singles have enough taxable income to benefit from cuts in the higher bracket rates.

  Many families will see their tax cuts reduced or eliminated by the AMT, especially families that itemize deductions and live in states with relatively high state and local income taxes. In fact, many married, two-earner couples with children, who currently face some of the highest marriage penalties, will receive no tax cut after the first few years.

- By 2004, the AMT will begin to reduce the tax cut for some married couples with two children and $170,000 to $380,000 in income (in 2001 dollars); by 2005, the AMT will completely eliminate the cut for certain families with incomes of around $200,000.

- Over time, the range of married-couple families with reduced or eliminated tax cuts widens dramatically. By 2010, many married couples with two children and gross incomes as low as $75,000 in 2001 dollars will see their tax cut reduced by the AMT, and many families with gross incomes as low as $120,000 will receive no cut. Meanwhile, families with gross incomes above $690,000 will remain unaffected by the AMT, leaving their tax cut fully intact.

The lack of relief provided to a rapidly growing number of AMT families will create strong political pressure to address the AMT problem. Thus, a more realistic cost estimate of the tax bill should include the cost of AMT relief, as well as the cost of not sunsetting the tax cuts.

- Accounting for just the AMT raises the true cost of this tax cut to around $1.7 trillion over eleven years. Further, adding the cost of extending the tax bill to the end of the budget window brings the total 2001-11 cost to $1.8 trillion. A full accounting might well include the permanent costs of the slowly phased-in provisions or any additional costs from extending other tax provisions.

Although the President claims this tax plan provides a sizeable tax cut for all income tax payers, this analysis shows that many taxpayers will not receive the tax cuts they expect. Many provisions are slow to take full effect, the benefits to single, childless taxpayers are limited, and the AMT will erode the cuts for an increasing number of families.

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What Do Families Really Get from the Tax Cut?

I. <u>Introduction</u>

In the Economic Growth and Tax Relief Reconciliation Act of 2001, Congress modified the President's original tax plan to provide more tax relief for lower-income working families and add additional tax benefits for retirement saving and education, while still remaining within a $1.35 trillion, 11-year budget constraint.

A smaller reduction in the top marginal tax rate paid for some of these extras–although eliminating the phase-outs of itemized deductions and personal exemptions at higher incomes offset some of the reduced tax cut for higher-income taxpayers. Most of the additional tax relief was squeezed into the budget constraint through a series of budgetary maneuvers and gimmicks. These included stretching out the phase-in of the tax cuts, delaying implementation of some provisions until the second five years, "sunsetting" other provisions after the fifth year, and sunsetting the entire Act at the end of 2010.

In addition, although the Tax Act contains a small amount of relief from the Alternative Minimum Tax (AMT) in 2001 through 2004, it relies on the AMT in later years to pay for a significant part of the tax cut, by reducing or eliminating the benefits of the tax cut for an increasing number of families over time.

Existing information on how different families benefit from this tax cut can be confusing because the calculations often show only the fully phased-in version of the tax cut, which does not actually apply until many years from now. In addition, analyses that overlook the effect of the AMT, or fail to reflect the fact that key features of the AMT are not indexed for inflation, miss how severely the benefits will be eroded over the life of the Tax Act.

This paper calculates the tax cuts for different representative families over each of the next ten years. It highlights that while Congress did redirect more tax relief toward lower-income families than the President's plan did, the relative benefits to the highest-income households will still grow dramatically over the 2001-10 period, as the cuts in marginal tax rates for higher-income taxpayers and the repeal of the personal exemption and itemized deduction phase-outs take effect. It also shows a sometimes-overlooked feature of the tax bill, namely that single, childless taxpayers will receive a very small benefit from the tax cut, which will shrink over time for most.

The paper also presents calculations showing that certain families will see reduced or eliminated tax cuts because of the AMT, and that many two-earner families with children will in fact get *no* tax benefit from this bill after the first few years. The lack of relief provided to these families makes it all the more likely that the public will demand action on the AMT problem, and soon. Thus, a calculation of the true cost of this tax bill should include not only the missing final-year cost of the tax cut, but also future AMT relief. This relief has been made even more costly because of this bill, and enacting it will tilt tax relief in favor of higher-income families to an even greater extent than the current Tax Act.

The paper shows only the effects of the key income tax provisions. It does not include the effects of the reduction and repeal of the estate tax or other features of the Tax Act that increased child care credits and added incentives for education and retirement saving.

II. Effects of the Tax Cut on Different Types of Households

A Tax Act this complex provides widely varying benefits to households of different types and sizes. These effects also vary over time. This section highlights some major conclusions that can be drawn concerning specific effects on different types of families.

The distribution of the tax cut by income level changes over the budget window. Although lower-income households are major beneficiaries of the tax cut in the early years, over time the gains to upper-income households increase in relative importance. In 2001, the pattern of the tax cuts is dominated by two factors: the increase in the child credit from $500 to $600 and the reduction in the tax rate from 15 percent to 10 percent on the first $12,000 of taxable income for married couples, $10,000 of taxable income for head of household filers, and $6,000 of taxable income for single taxpayers. Taken together, these two provisions reduce taxes by $800 for married couples with two children, and by $700 for a single parent with two children (**Table 1**).

Families with incomes taxed at rates above 15 percent also receive a small immediate benefit from the first year cut in marginal rates in higher tax brackets; some higher-income households will also benefit from the increase in the AMT exemption. Lower-income families also receive a larger tax cut than other families due to the refundability of the child credit.

Over the next ten years, however, a number of factors change this distribution. First, further reductions in marginal tax rates in higher tax brackets do not fully take effect until 2006, when the final installment of the rate cuts drops the top rate from 37.6 percent to 35 percent and reduces other rates by one percentage point. The elimination of personal exemption and itemized deduction phase-outs does not begin until 2006, and those provisions are not completely repealed until 2010. Those changes increase the relative tax cuts for the highest-income households.

Second, the increase in the standard deduction and the extension of the 15 percent bracket for married couples phase in during the second five years. An increased standard deduction helps all married couples who do not itemize deductions. The extension of the 15 percent bracket helps only those married couples with taxable income above the 15 percent bracket–about 40 percent of married couples filing joint returns in 1997.

Third, more high-income families get pushed onto the AMT after 2004, so that their tax cuts decline or even disappear completely. The AMT, however, will not affect the highest-income families.

By 2010, the real dollar value of the tax cut to a married couple with two children and $20,000 in gross income (in 2001 dollars) will double. But for families with $500,000 or $1 million in income, the tax cut will increase six-fold and ten-fold, respectively. However, some families with $200,000 in income will actually have lost their tax cut entirely because of the AMT.

For a single parent with two children and income of $40,000 or less, the tax cut will actually decrease in real value from 2001 through 2004. In 2005, when the value of the child credit increases from $600 to $700 per child, the tax cut will increase, but then it will decline again until the child credit increases again in 2009 and 2010.

The percentage change in after-tax income also shows a change in distribution over time (**Figure 1**). For example, in 2001 a married couple with two children and income of $20,000 would see about a 4.8 percent increase in after-tax income, more than double the percentage increase of 1.9 percent for comparable families with income of $50,000, and dwarfing the 0.8 and 0.7 percent increases for families at $200,000 and $1 million, respectively (although the dollar value of their tax cuts would still substantially exceed the cut received by the lower-income families).

By 2010, however, the pattern changes: no longer do percentage increases in after-tax income fall at higher gross income levels. The percentage increase in after-tax income for the $20,000 family (9.6 percent) still exceeds that for the $1 million family (7.0 percent), but by a much smaller amount, while the boost to families at $200,000 is completely eliminated due to the AMT. Overall, the tax cut produces a U-shape pattern of percentage changes in after-tax income.

Without the AMT, the pattern of tax cuts relative to income would look quite different (**Figure 2**). If taxpayers were not subject to the AMT, families with incomes starting at about the equivalent of $75,000 in today's dollars would receive a bigger tax cut in 2010, and the distribution of tax cuts would not be as progressive over the middle-to-high income range. Families with incomes of about $20,000 in today's dollars would still receive the largest tax cuts as a percentage of after-tax income.

Refundability helps low-income families.
Low-income families benefit from the Tax Act largely because of the refundability of the child credit, which was added to the original Administration proposal by the Senate, and in a much more limited form by the House. Under the Tax Act, which closely follows the Senate version, low-income families receive refundable child credits of up to 10 percent of their earnings (15 percent beginning in 2005) in excess of $10,000. Families are eligible for the refundable credit beginning in 2001.

Refundability allows working families without income tax liability--but who pay payroll taxes--to receive some benefit from the tax cut, and it increases the tax cut for lower-income working families with small income tax liability. Under the original Administration proposal, a married couple with two children and income of $25,000 or less would not have received any tax cut. Under the Tax Act, low-income families with children can receive a small refundable credit once their earnings exceed $10,000. For example, a married couple with two children and income of $15,000 can expect to receive a refundable credit of $500 in 2001.

The Tax Act makes the child credit refundable for many more families, but it also phases-in the increase in the credit over the next decade. The per-child credit does not reach $1,000 until 2010, by which time it is worth less than $800 in today's dollars. The credit reverts back to $500 by 2011, when the Act sunsets. In addition, unlike all other tax brackets, the new 10 percent bracket is not indexed for inflation until 2009, and although the end point of the 10 percent bracket is extended by $1,000 for single filers and $2,000 for married couples in 2008, it is not increased for heads of households. Thus, for heads of households the tax saving from the lower tax rate will diminish over time when measured in today’s dollars.

The net result is that many taxpayers will not receive the tax cuts originally advertised by proponents of the tax bill. Had the bill provided an *immediate* doubling of the child credit to $1,000 per child, plus the addition of the 10 percent bottom tax rate, a working single mother with two children would have received a tax cut of $1,500 in 2001 ($1,000 from the child credit, and $500 from the bottom rate reduction). The timing of provisions in the final bill, however, prevents a single parent with income between $25,000 and $45,000 from ever seeing a tax cut of that size in today’s dollars (**Figure 3**).

Relief for single, childless households is limited.

With the expansion of the child credit and the provisions for marriage penalty relief, most of the benefits of this Tax Act are directed toward married couples and families with children. Single, childless taxpayers will see some reduction in taxes from the lower tax rates, but for most singles those cuts will be small.

The new 10 percent bracket covers only the first $6,000 of taxable income for singles in 2001, resulting in a tax cut of $300 for those singles with at least $6,000 of taxable income. Singles with less income will see a smaller tax cut. Singles with taxable income above the starting point for the 28 percent bracket ($27,050 in 2001) will also benefit from the cut in tax rates in higher brackets, but relatively few singles have that much taxable income. In 1997, the latest year for which statistics are available, only 25 percent of single returns had any taxable income in excess of the 15 percent bracket.

Because the $6,000 ceiling on the new 10 percent bracket for singles does not increase until 2008 and is not indexed until 2009, the $300 tax cut for singles will decline in real value over time. For example, by 2007 a single tax filer with $30,000 of income in today's dollars will receive the equivalent of a $257 tax cut (**Table 2**). The increase in the ceiling for the 10 percent bracket will bump up the tax cut to about $290 in 2008, where it will remain until 2010.

The Alternative Minimum Tax reduces or eliminates tax cuts for some families.
The Alternative Minimum Tax was created to ensure that high-income households would not be able to shelter large fractions of their income from taxes. It requires that taxpayers recompute their liability based on a broader-based definition of income, but that income is subject to a flatter rate structure with marginal rates of 26 and 28 percent.

If the AMT liability is higher than that obtained through the ordinary income tax structure, the household pays an amount equal to the AMT instead. Because the top AMT rate of 28 percent is considerably lower than the previous top marginal rate under the ordinary income tax (of 39.6 percent), the very highest-income households would be less likely to face AMT liability than households in the previous 31- and 36-percent brackets, with slightly lower (but still high) gross incomes. (At very high incomes, the effect of the high marginal rate under the ordinary income tax outweighs the effect of the broader AMT base.)

The AMT was already a problem that was expected to worsen even *before* the Tax Act. The AMT replaces personal exemptions and the standard deduction with a fixed exemption amount for married couples and single taxpayers. This exemption is not indexed for inflation, so over time increasing numbers of taxpayers with lower incomes will be subject to the AMT. Further, under the AMT taxpayers who itemize their deductions cannot deduct state and local income taxes, which are allowable deductions under the regular tax. Thus, taxpayers in higher income tax states are more likely to find themselves paying the AMT.

When the Taxpayer Relief Act of 1997 added new personal income tax preferences, experts pointed out that the new cuts meant that more families would become subject to the AMT than would have been the case under prior law. This year's Act makes the situation even worse.

The Act is designed to provide relief to all taxpayers, but *particularly* married households with children. However, families with children, in certain income ranges, are actually the most likely to see their benefits eroded by the AMT. Although families can claim child credits under the AMT, the advantages of lower marginal tax rates are lost. In addition, other features of the Tax Act such as the repeal of the personal exemption phase-out that would have reduced taxes for higher-income families with children, provide no benefit to families that are subject to the AMT.

While the modest amount of AMT relief in the first four years (from an increased AMT exemption level) prevents benefits from eroding initially, by 2004 the AMT will begin to reduce the tax cut for some married couples with two children and $170,000 to $380,000 in income (in 2001 dollars), depending upon the extent of their state and local income tax deductions, and by 2005 it will completely eliminate the cut for certain families with about $200,000 in income (**Figure 4**).

Over time, the range of married-couple families with reduced or eliminated tax cuts due to the AMT widens dramatically. By 2010, many married couples with two children and gross income as low as $75,000 (in 2001 dollars) will see their tax cut reduced by the AMT, and many families with gross income as low as $120,000 will get *no* cut. Meanwhile, the AMT will leave fully intact the tax cuts for families with gross incomes exceeding $690,000.

While the particular timing of when certain families lose all or part of their tax cut depends upon the amount of state and local income tax deductions they claim, the AMT will eventually reduce or eliminate the tax cut for families in these income ranges even if they claim no tax deductions. Moreover, the impact of the AMT will be even worse for families who claim additional personal credits, such as for child care expenses, that are not allowable under the AMT.

III. Budgetary Implications

The tax plan relies on unsustainable budget strategies that will only become more untenable over time. In order to fit into the $1.35 trillion, 2001-11 budget, many of the features that have the largest permanent costs are phased in very slowly, and the entire Act terminates at the end of 2010 (artificially reducing the cost in the last year). The treatment of the AMT just adds to the understatement of true costs: not only does the Act ignore existing AMT issues, it uses the increasing scope of the AMT to obscure further the true cost of the bill, while making the AMT problem worse and even more costly to fix.

The above calculations show how the AMT will eventually eliminate some or all of the tax cut over a wide income range for many two-earner families with children, despite the limited AMT relief provided over the first few years. This is not a trivial segment of the population; hence, eroding the tax cut for taxpayers already on or entering the AMT significantly reduces the official cost of the tax bill.

The Joint Committee on Taxation (JCT) estimates that while the number of taxpayers affected by the AMT under current law would have risen to 17.5 million by 2010 (from 1.5 million this year), that number will more than double–to *35.5 million*–as a result of the tax bill. That is nearly one-third of all taxpayers in 2010, according to a June 2000 Treasury Department analysis.

While the JCT did not estimate the cost of eventually fixing the AMT as a result of the conference agreement bill, its estimates for earlier versions of the President's tax bill suggest that the plan's incremental effect alone could add between $300 and $400 billion to the 11-year cost of more permanent AMT relief.

In other words, the conference agreement's true cost, after accounting for the AMT problem alone, is raised to around $1.7 trillion over eleven years. Adding the expense of extending the tax bill to the end of the budget window (instead of allowing the sunsetting at the end of 2010) brings the total 2001-11 cost to $1.8 trillion (**Figure 5**). Because of the phase-ins, the cost in the next 10 years is substantially larger. Nor do these costs include other likely tax actions, such as extending the research and experimentation tax credit.

IV. Conclusion

Although the President claims this Tax Act provides a sizeable tax cut for all income tax payers, this analysis shows that many taxpayers will not receive a tax cut as large as they might expect. Many provisions are slow to take full effect, the benefits to single, childless taxpayers are limited, and finally, the AMT will erode the cuts for an increasing number of families with children.

Despite the addition of further tax relief to lower-income families, the dollar value of the tax cut is still heavily skewed toward the highest-income households and this uneven distribution increases over time. In addition, the budgetary implications of the Act are disturbing. Official estimates understate the true cost because of gimmicks such as delayed phase-ins and sunsets. Finally, the Act relies on the AMT to pay for part of its cost, while making that problem only more severe and costly to fix in the future.

Table 1

Dollar Amount of Tax Cut for Families with Children

(2001 dollars)

Married Couple with Two Children

Adjusted Gross Income	Current Law Income Tax 2001	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
$10,000	-4,000	0	0	0	0	0	0	0	0	0	0
$20,000	-2,553	1,000	1,204	1,198	1,191	1,600	1,599	1,562	1,700	1,834	2,022
$30,000	173	740	936	932	917	1,301	1,341	1,325	1,502	1,707	2,018
$40,000	2,120	800	778	758	739	941	997	986	1,077	1,302	1,614
$50,000	3,335	800	778	758	739	901	879	858	921	1,076	1,381
$75,000	6,886	820	816	796	813	1,365	1,230	1,201	1,172	1,306	1,592
$100,000	12,556	921	1,019	999	1,218	1,363	1,123	918	774	796	971
$200,000	38,110	1,136	1,654	1,640	1,218	0	0	0	0	0	0
$500,000	136,557	2,454	4,291	4,275	7,966	8,344	15,458	15,378	15,298	15,229	15,168
$1,000,000	302,877	4,554	8,491	8,475	16,366	16,744	37,768	37,924	42,591	42,562	46,961

Head of Household with Two Children

Adjusted Gross Income	Current Law Income Tax 2001	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
$10,000	-4,000	0	0	0	0	0	0	0	0	0	0
$20,000	-2,553	735	709	670	650	811	768	744	720	845	1,133
$30,000	751	700	681	663	646	811	791	772	753	908	1,214
$40,000	2,555	700	681	663	646	811	791	772	753	908	1,214
$50,000	3,770	700	681	663	646	811	791	859	1,008	1,306	1,592
$75,000	8,862	779	838	821	958	890	775	667	560	617	828
$100,000	15,532	680	846	834	1,048	353	184	0	0	0	0
$200,000	41,655	672	506	492	517	0	0	0	0	0	0
$500,000	138,931	2,399	4,284	4,270	8,053	8,041	16,002	15,994	17,685	17,615	17,554

Note: Assumes all income is from earnings, both spouses in the married couple work, both children qualify for the child credit, itemized deductions are 19 percent of income, and state and local income tax deductions are 40 percent of total itemized deductions.

Source: Joint Economic Committee, Democratic Staff.

Table 2

Dollar Amount of Tax Cut for Single Households

(2001 dollars)

Adjusted Gross Income	Current Law Income Tax 2001	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
$10,000	328	128	128	128	126	126	127	127	126	127	126
$20,000	1,883	300	292	284	277	270	264	257	293	292	293
$30,000	3,210	300	292	284	277	270	264	257	293	292	293
$40,000	4,744	312	316	308	323	316	333	326	361	361	362
$50,000	7,012	353	397	389	485	478	576	569	604	604	605
$75,000	12,682	454	599	591	890	883	1,183	1,177	1,212	1,212	1,212
$100,000	18,728	555	802	794	1,295	1,288	1,791	1,784	1,819	1,819	1,820
$200,000	46,240	978	1,648	1,640	2,988	2,965	2,526	2,095	1,674	1,271	871
$500,000	141,715	2,245	4,181	4,173	8,053	8,046	15,426	15,420	17,080	17,073	18,698

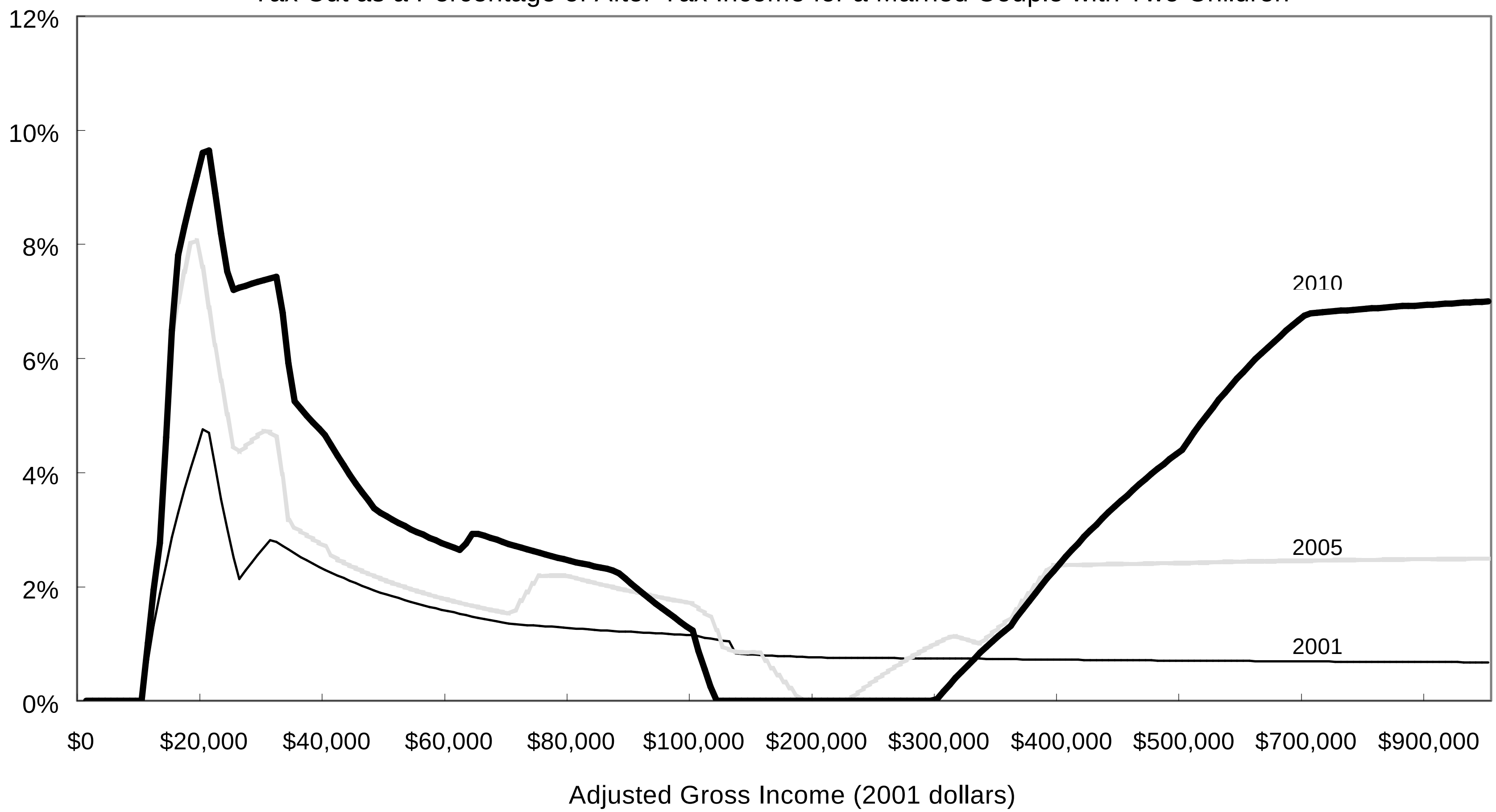
Note: Assumes all income is from earnings, itemized deductions are 19 percent of income, and state and local income tax deductions are 40 percent of total itemized deductions.

Source: Joint Economic Committee, Democratic Staff.

Figure 1

Benefits Shift in Favor of Higher-Income Families over Time

Tax Cut as a Percentage of After-Tax Income for a Married Couple with Two Children



Note: Assumes all income is from earnings, both spouses work, both children qualify for the child credit, itemized deductions are 19 percent of income, and state and local income tax deductions are 40 percent of total itemized deductions.

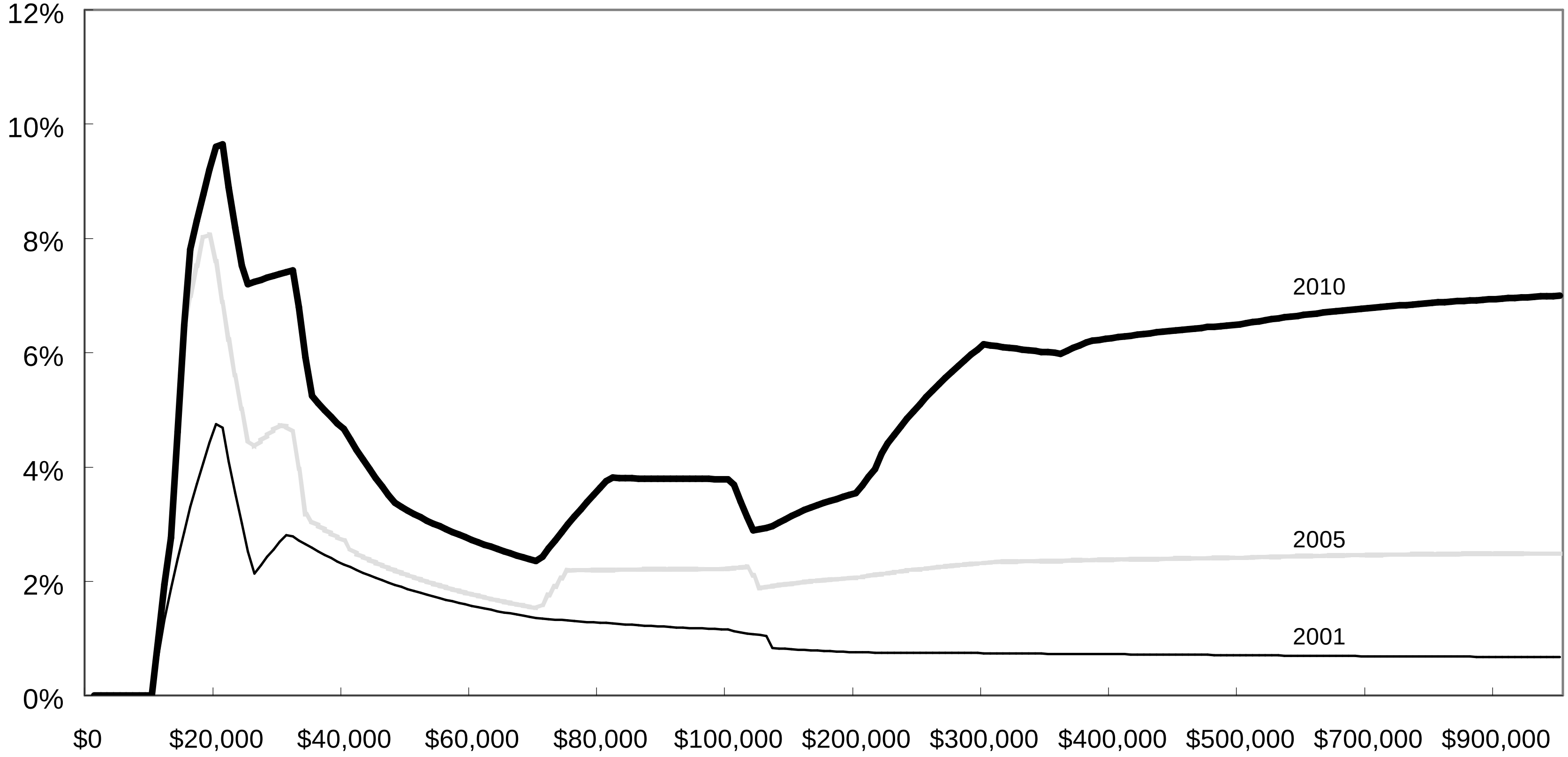
Source: Joint Economic Committee, Democratic Staff.

Figure 2

Tax Cut Would Be Less Progressive If Not for the AMT

Tax Cut as a Percentage of After-Tax Income for a Married Couple with Two Children

In the Absence of the AMT



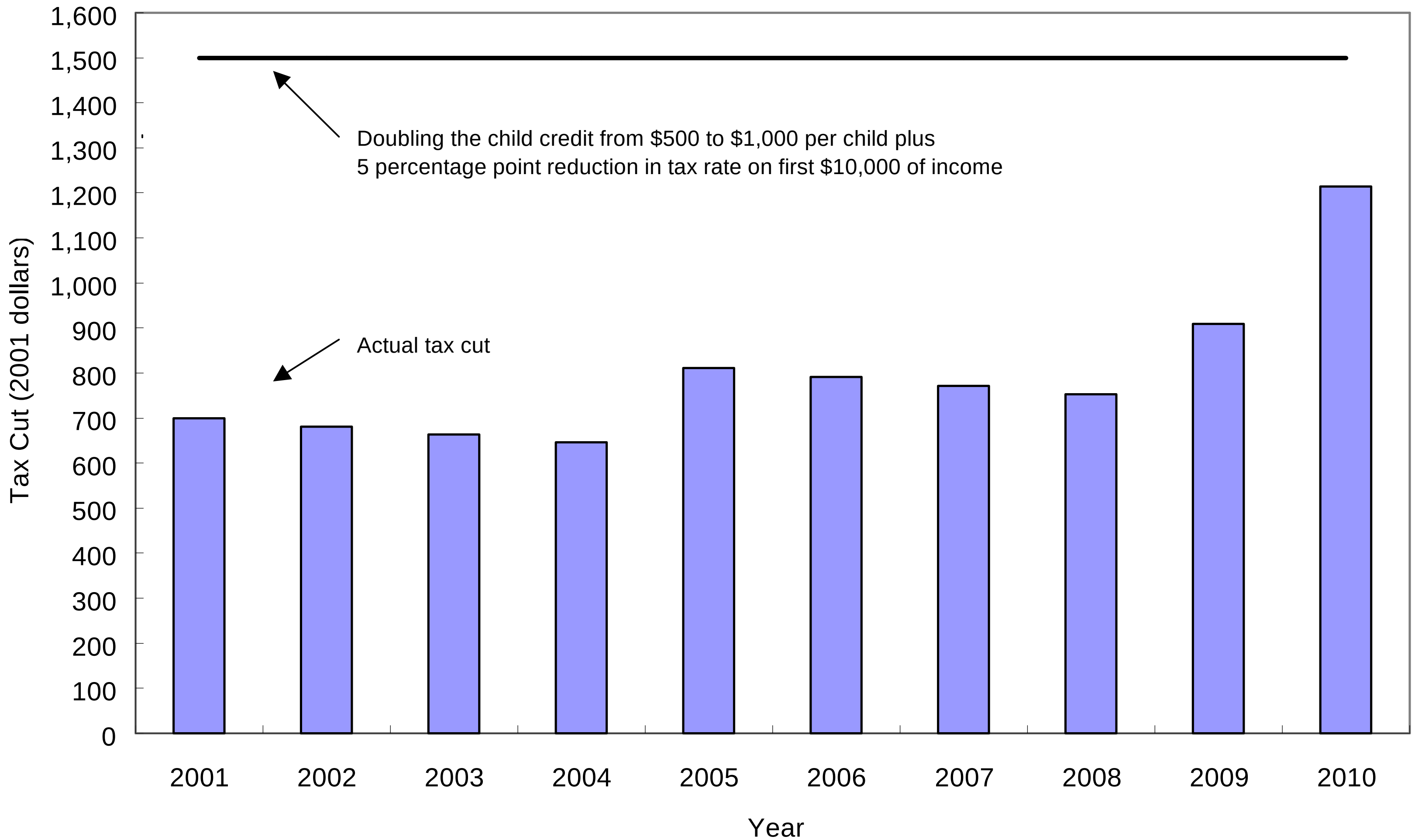
Note: Assumes all income is from earnings, both spouses work, both children qualify for the child credit, itemized deductions are 19 percent of income, and state and local income tax deductions are 40 percent of total itemized deductions.

Source: Joint Economic Committee, Democratic Staff.

Figure 3

Tax Cut Is Less Than Promised for Single Parents

Tax Cut for a Single Parent with Two Children and Income between $25,000 and $45,000

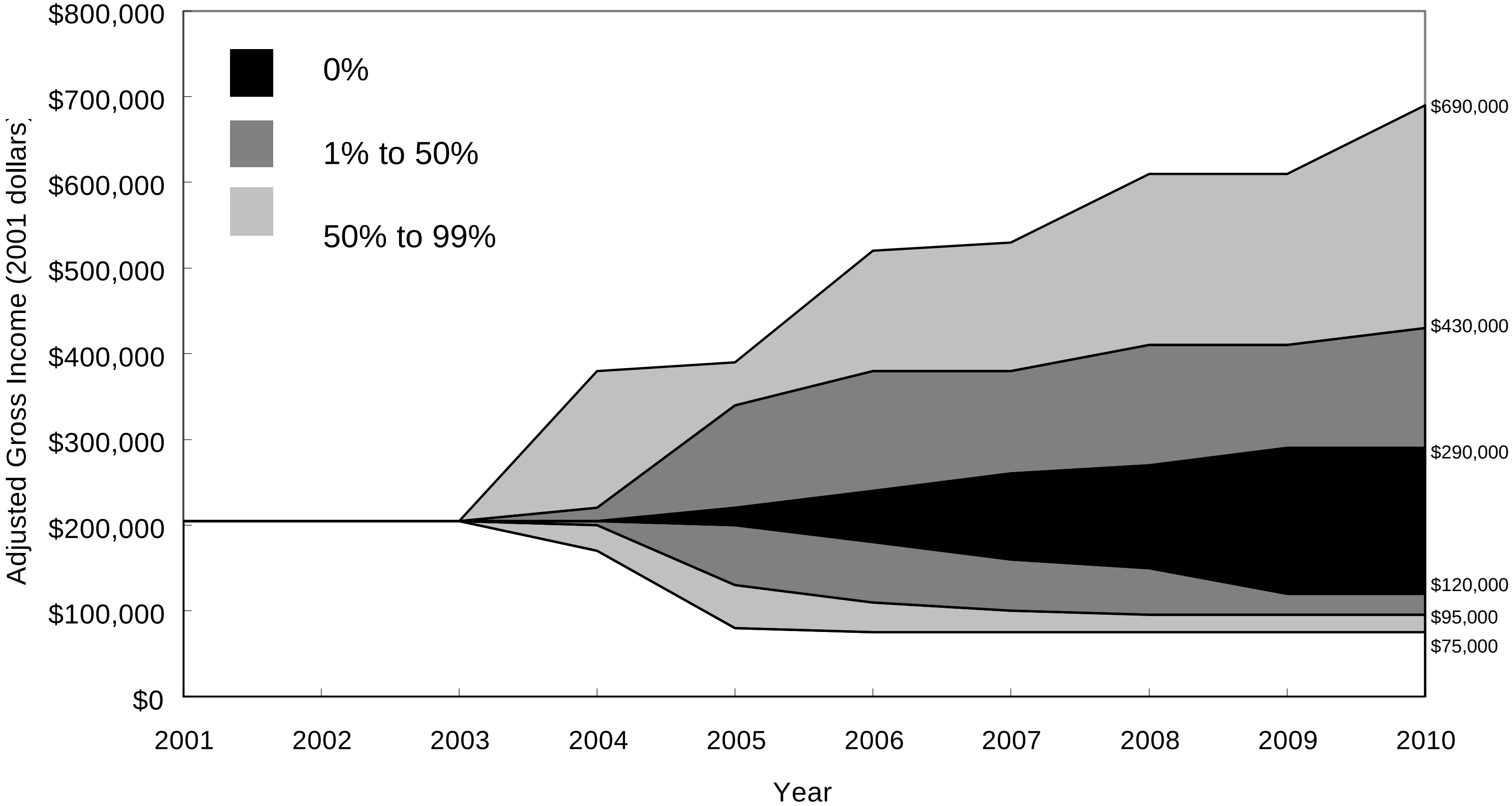


Source: Joint Economic Committee, Democratic Staff.

Figure 4

AMT Reduces or Eliminates the Tax Cut for Many

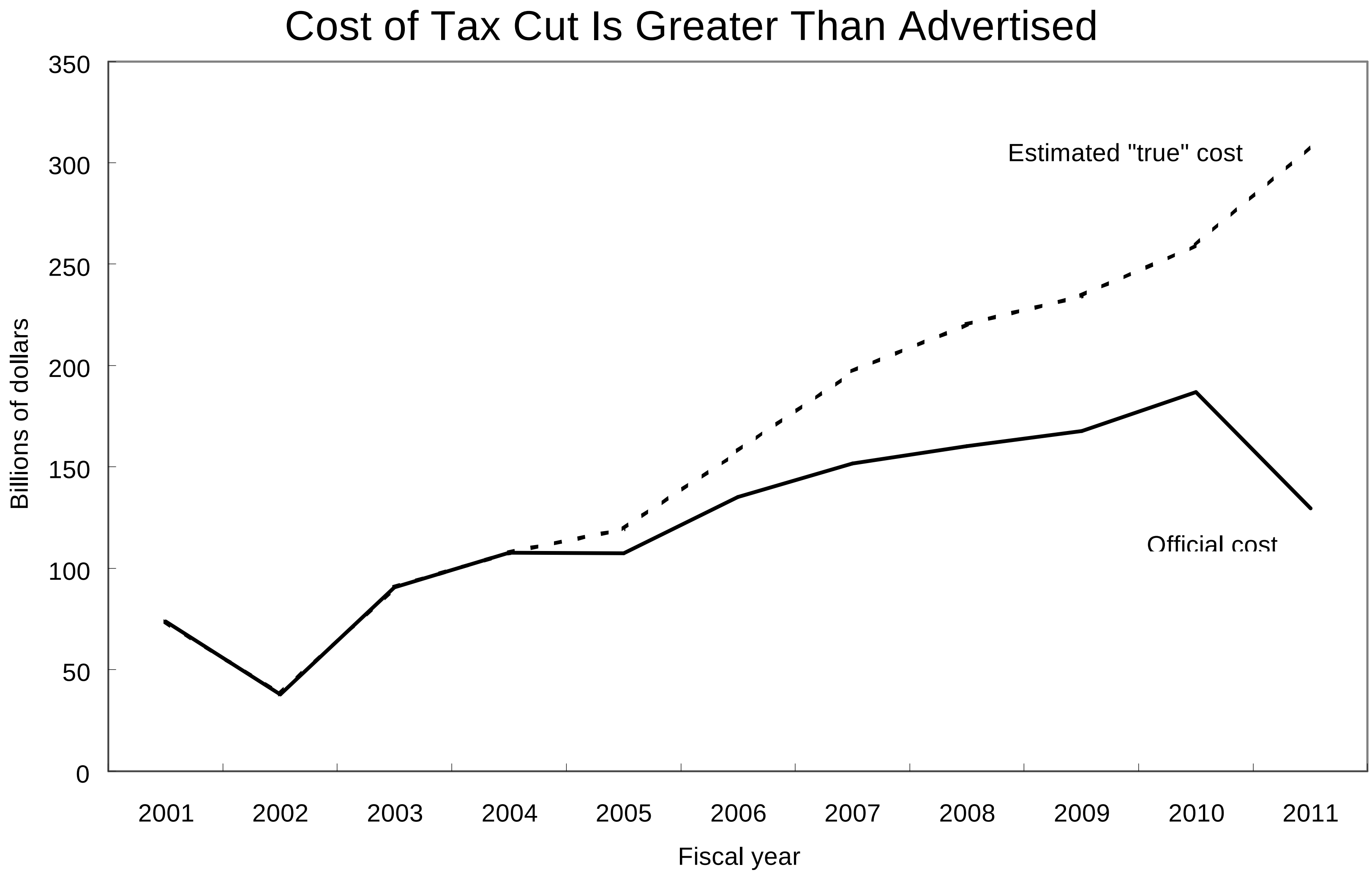
Percent of Tax Cut Remaining after AMT for a Married Couple with Two Children



Note: Assumes all income is from earnings, both spouses work, both children qualify for the child credit, itemized deductions are 19 percent of income, and state and local income tax deductions are 40 percent of total itemized deductions.

Source: Joint Economic Committee, Democratic Staff.

Figure 5



Sources: Official cost is from Joint Committee on Taxation; estimated "true" cost is based on Center on Budget and Policy Priorities estimates.